

Private Letter Ruling: Request for alternative apportionment granted. (This letter was not previously indexed or included in a monthly report because the daily file copy was misfiled.)

March 2, 1999

Dear:

This is in response to your letter dated February 19, 1999, in which you request a Private Letter Ruling on behalf of xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx. The Private Letter Ruling will bind the Department only with respect to xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx. for the issue or issues presented in this ruling. Issuance of this ruling is conditioned upon the understanding that neither xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx nor a related taxpayer is currently under audit or involved in litigation concerning the issues that are the subject of this ruling request.

The facts and analysis as you have presented them in your letter are as follows:

We are filing this petition to request permission for the above noted taxpayer to use a separate accounting method in determining the portion of net income allocable to and taxable by Illinois.

xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx (xxxxxxx) is a limited liability company which trades stocks and options contracts for its own account as members of the American Stock Exchange and the Chicago Board of Options Exchange. The firm's activities are conducted by trading members, each of whom is responsible for trading a separate account.

In order to generate income, the traders buy and/or sell various options contracts and hedge these options positions by buying or selling the underlying stock. The goal of the trading is to maximize income while minimizing the risk inherent in dealing with options. The income consists of the change in value of the security positions, the interest paid or collected on cash borrowed or received from the purchase or sale of the securities and the dividends paid or received on the stock positions.

A typical transaction might take the following form. A trader will sell stock (let's say IBM) at \$99 per share. This is a short sale, meaning that the trader will later have to purchase the stock in order to close the position. Simultaneously, the trader will buy a call permitting him to purchase IBM for \$100 per share at any time until the call expires, let us say in September 1998. The trader is said to be "long" the call. The trader will also sell a put expiring in September that will permit the owner of that put to sell IBM to the trader for \$100 per share at any time until expiration. The trader is now "short" the put.

This "long" call, "short" put position is called artificial stock. Under any set of circumstances, the trader will acquire IBM stock for \$100 per share at the expiration of the options. If IBM is trading for more than \$100 per share, the trader will exercise his call. If it is trading for less, the owner of the put will exercise the put. The trader will therefore lose \$1 per share on the stock portion of the transaction, selling it for \$99 and buying it for \$100.

The above example does not, however, take into account the cost of the put and call, dividends and interest. Let's pretend that he will

pay \$1 more for the call than he will receive for the put. This dollar will be lost since the options will be held until expiration. Let's also pretend that IBM will pay one dividend of fifty cents before September and that cash in the traders' account earns 6% interest per year. This position will be established in March, a half year before the options expire.

The trader would make approximately forty four cents per share from this position as follows:

Loss on the stock	1.00>
Loss on the options	1.00>
Dividend paid	.50>
Interest earned ($\$98 \times .06 \times 1/2$)	<u>2.94</u>
Net income	<u>.44</u>

Since actual positions are much more complex than this example and are constantly changing, the trader will be constantly buying and selling both stock and options positions. The income earned by the trader will consist of a combination of stock and/or options profits or losses and interest and dividend income or expense. The trader doesn't really care about the components, since only the net economic result is important.

But Illinois should care. Since the stock transactions typically take place on the New York Stock Exchange, any gains and losses from the stock positions are probably not sourced to Illinois, but rather to New York. In fact it is entirely random and arbitrary as to which component of the positions held by a trader make the profit. Using the traditional three-part formula will never reasonably allocate the correct portion of receipts to Illinois.

Furthermore, even though property is not an income generating factor, since the taxpayer does not own any property in Illinois, but does own property elsewhere, the property factor will always be zero in Illinois.

Finally, if required to use the three-part formula, taxpayer can employ someone outside of Illinois to perform certain administrative tasks now handled by independent contractors to create a payroll factor of zero.

Taxpayer maintains its financial records on a basis conducive to separate accounting. Each trader has an account which records the trading activity of that particular trader. All expenses related to that trader's activities are deducted from the account. Consequently, it is relatively easy to determine the net income generated by each trader. Since a trader conducts his activity on the floor of one of the options exchanges, it is easy to determine how much income is generated within a given state.

Taken together, the use of the three-part formula will never accurately and fairly reflect the business activity taking place in Illinois. On the other hand, the separate accounting method will always fairly reflect the business activity taking place in Illinois and should therefore be permitted.

In telephone conversations, you further represented that xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx has no employees. All of its business activities are carried out by its members or by independent contractors, such as attorneys and public accounting firms. Also, the only tangible property owned by xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx is office equipment, none of which is located in Illinois. Finally, the compensation of each member of xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx is based on the income allocated to that member's account as described above.

Ruling

Section 304(f) of the IITA provides:

If the allocation and apportionment provisions of subsections (a) through (e) do not fairly represent the extent of a person's business activity in this State, the person may petition for, or the Director may require, in respect of all or any part of the person's business activity, if reasonable:

- (1) Separate accounting;
- (2) The exclusion of any one or more factors;
- (3) The inclusion of one or more additional factors which will fairly represent the person's business activities in this State; or
- (4) The employment of any other method to effectuate an equitable allocation and apportionment of the person's business income.

Section 304(a) of the IITA provides that:

If a person other than a resident derives business income from this State and one or more other states, then, for tax years ending on or before December 30, 1998, and except as otherwise provided by this Section, such person's business income shall be apportioned to this State by multiplying the income by a fraction, the numerator of which is the sum of the property factor (if any), the payroll factor (if any) and 200% of the sales factor (if any), and the denominator of which is 4 reduced by the number of factors other than the sales factor which have a denominator of zero and by an additional 2 if the sales factor has a denominator of zero. For tax years ending on or after December 31, 1998, and except as otherwise provided by this Section, persons other than residents who derive business income from this State and one or more other states shall compute their apportionment factor by weighting their property, payroll, and sales factors as provided in subsection (h) of this Section.

Section 304(h) provides that, for taxable years ending on or after December 31, 1998 and before December 31, 1999, the weighting given to the payroll and property factors shall each be $16 \frac{2}{3}\%$, and the weighting given to the sales factor shall be $66 \frac{2}{3}\%$.

For purposes of computing the sales factor, Section 304(a)(3) of the IITA provides that:

(C) Sales, other than sales of tangible personal property, are in this State if:

(i) The income-producing activity is performed in this State;
or

(ii) The income-producing activity is performed both within and without this State and a greater proportion of the income-producing activity is performed within this State than without this State, based on performance costs.

(D) For taxable years ending on or after December 31, 1995 and excluding taxable years ending after December 31, 1997, the following items of income shall not be included in the numerator or denominator of the sales factor: dividends; amounts included under Section 78 of the Internal Revenue Code; and Subpart F income as defined in Section 952 of the Internal Revenue Code. No inference shall be drawn from the enactment of this paragraph (D) in construing this Section for taxable years ending before December 31, 1995.

Based upon your representations, xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx has no property which can be considered an income-producing factor. Nevertheless, under Section 304(a) of the IITA, the property of xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx would be included in the property factor, and would comprise 20% (or 16 2/3% if xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx were to hire an employee) of the apportionment formula.

In addition, you have represented that xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx has no employees, and therefore no payroll factor. xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx could hire a single employee whose compensation would be the entire payroll factor under Section 304(a), which in turn would comprise 16 2/3% of the apportionment formula.

Based on your representations of the typical transaction in which xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx engages, it would be difficult, if not impossible, to identify each component of a transaction, the costs of performance incurred within each state which are associated with the transaction and the gross receipts attributable to transaction. Moreover, under Section 304(a)(3)(D), dividends -- which could comprise a significant portion of the gross receipts of a particular transaction -- are excluded from the sales factor altogether in taxable years ending on and after December 31, 1995. Under the facts as you have represented them, the computation of the sales factor for xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx under Section 304(a) would be difficult and would not reflect the business activities of xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx in Illinois.

Based on your representations of the activities of the trader/members of xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx and of the interest each trader/member has in insuring the accuracy of the allocation of net income to his or her account, we conclude that apportioning to Illinois the net income allocated to the account of each trader/member operating in Illinois will fairly represent the extent of the business activities of xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx in this State.

Grant of Section 304(f) Petition

The petition of xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx under Section 304(f) of the IITA to use the alternative apportionment formula described in this ruling is hereby

granted, and xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx may use that apportionment formula for Illinois Income Tax returns due (including extensions) 120 days after February 19, 1999, the date the petition was filed.

Please note that this ruling does not affect the manner in which each member of xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx must apportion his or her share of the base income of the entity. Under Section 301(a) of the IITA, a resident must include 100% of his or her share of the base income of the entity in his or her Illinois net income, regardless of how that base income is allocated or apportioned by the entity. Under Section 305 of the IITA, a nonresident member of a limited liability company treated as a partnership must allocate to Illinois his or her percentage share of the amount of business income apportioned to Illinois by the entity and must allocate his or her percentage share of the nonbusiness income of the entity as if he or she had received that income directly.

The facts upon which this ruling are based are subject to review by the Department during the course of any audit, investigation or hearing and this ruling shall bind the Department only if the material facts as recited in this ruling are correct and complete. This ruling will cease to bind the Department if there is a pertinent change in statutory law, case law, rules or in the material facts recited in this ruling.

Very Truly Yours,

Glen L. Bower
Director

by: _____
Bill Lundeen
Chief Counsel